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Will France's Policy Shift Be Enough?

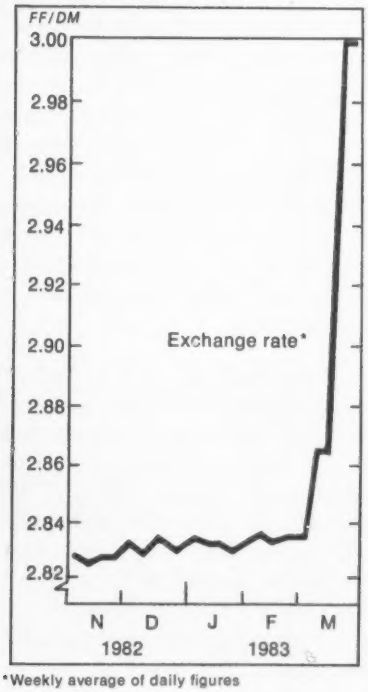
Last month's realignment of central rates in the European Monetary System (EMS) came as no surprise to the financial markets, well acquainted with the fundamental economic policy differences that had arisen between France and Germany.

France's strategy since 1981 had centered on stimulating economic activity through stepped-up deficit spending and increases in consumer purchasing power, with inflation suppressed via wage and price controls. The result was some continued growth but a skyrocketing of domestic credit expansion, as the higher public-sector deficit combined with the increased financing needs of a private sector whose profitability was severely squeezed. In Germany, by contrast, fiscal policy was tightened and, at least until recently, monetary policy remained relatively restrictive. As a consequence, France had large deficits in the current and private-capital accounts of the balance of payments while Germany had surpluses in both. In this environment the French authorities were effectively left with only two choices—a significant increase in the franc price of the mark or a Draconian cut in France's rate of monetary expansion. And given the rigidity of nominal wages, the latter course would have implied unacceptably high costs in terms of unemployment.

Without a shift in policy, last month's 8% devaluation of the franc in terms of the mark would probably not have been sufficient to prevent strains in the EMS from reemerging later in the year. Shortly after the change in EMS parities, however, Finance Minister Delors unveiled a tough package of public spending cuts, higher taxes, increased public-sector prices, and forced savings designed to reduce domestic demand this year by 2% in real terms. In addition, the 1983 target for M2 growth was cut from 10% to 9%, against a provisional estimate of 12.2% growth in 1982. As a result, although France will be lucky to see any real growth this year, the current-account deficit should decline sharply and the present EMS franc/mark rate seems likely to hold into 1984.

Assuming unchanged policy in Germany, how long this parity can be maintained depends on France's ability and willingness to reduce the rate of domestically generated monetary expansion. The costs in terms of foregone output and unemployment of such a monetary tightening vary inversely with the policymakers' ability to dampen wage increases and reduce real labor costs. Thus, the key to the franc/mark rate next year hinges on how successful the Mitterand government will be in its efforts to inject a more realistic attitude into French expectations of real wages.

The French franc price of the German mark



*Weekly average of daily figures

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Stronger Swiss franc ahead.

The Swiss franc slipped against the German mark in recent weeks, from 0.82 in January to a low of 0.87 in mid-March. Some of this fall reflected the mark's rise in anticipation of a formal realignment within the EMS and caused little concern to the authorities. As expected, the franc recovered somewhat once the realignment was actually announced. Nevertheless, the Swiss National Bank tightened its policy stance a little in order to narrow the gap between German and Swiss interest rates and thus guard against any further exchange-rate slippage. Looking further ahead, there is a good chance that the Swiss franc will appreciate again: Swiss economic growth is likely to lag behind Germany's and so give the country a substantial current-account surplus. Furthermore, the pressures that kept Swiss inflation above that of Germany for 10 months appear to be subsiding, which should enable Switzerland to once again enjoy the lowest inflation rate in Europe.

Unexpected devaluation of Dutch guilder likely to spur interest-rate decline.

The major, in fact the only, surprise of the recent EMS realignment was the 2% devaluation of the Dutch guilder relative to the German mark—a move not justified by economic fundamentals. Holland's inflation rate has been virtually identical to Germany's and, on the basis of unit labor costs, Holland has actually gained in competitiveness vis-à-vis Germany over the past two years. Moreover, the Netherlands has a massive current-account surplus, which in 1982 amounted to more than 4% of GDP. Given the country's fairly restrictive fiscal stance and now even-more-improved competitive position, another rise in the current-account surplus is forecast for 1983. At present, the guilder is expected to come under upward pressure in the EMS over most of 1983. And this suggests a decline in Dutch interest rates relative to those in Germany.

Sweden hoping to maintain single-digit inflation.

After long and difficult negotiations, Swedish labor organizations last month finally reached agreement on 1983 wage increases. With the devaluation of the krona last October, Sweden's Social Democratic government accepted the fact that inflation would be given an upward push. But at the same time, the policymakers warned that if the move was to have beneficial effects, the initial inflation pressures should not give rise to compensating pay increases. The latest settlements allow for a 1.9% rise, which, taken together with arrangements made under previous agreements, should hold the increase in earnings to some 8.4% for the year. This means that, although it has no hope of matching the low rates of inflation seen in Germany or Switzerland, Sweden should be able to keep its 1983 inflation rate in single digits after last year's 8.8%, which followed 12.1% and 13.7% in 1981 and 1980, respectively. Other aspects of the economy also look more encouraging: After almost no growth in 1982, GDP is expected to record a 1.8% rise this year with every prospect of a still higher figure next year. In addition, the current-account deficit should narrow from 1982's $3.6 billion shortfall and, as a result, help to reduce Sweden's overseas borrowing needs.

Devaluation and fiscal stringency in Ecuador.

Ecuador has devalued the sucre and reduced the fiscal deficit in a dual effort to promote exports and restrain import demand. The official exchange rate has been set at 42 sucres per U.S. dollar, down from 33, with further regular adjustments to be made subsequently. In addition, 30% of non-traditional exports are now permitted to be cleared on the free-exchange-rate market, which as of last week was quoted at 82 sucres per dollar. Imports are being restricted through direct measures and by putting more items also on the free market. The government is also using demand management measures to dampen both imports and the inflationary pressures resulting from the devaluation. Policymakers are aiming to keep budget growth limited to 5% per year—despite high inflation expectations—and much public-sector employment has been frozen. The intent of these measures is to reduce the country's current-account deficit, which, because of falling oil export income, widened to $1.2 billion last year. Reduction of the deficit is urgent in view of the currently low, $150-million level of international reserves and the need to refinance much of the country's public-sector external debt.

Canadian economy still waiting for an upturn.

Recently released statistics on the Canadian economy have demonstrated just how bad the past year was—and how uncertain the future still is. A 4.8% drop in real GNP last year indicated that, among developed countries, Canada was one of the hardest hit by the world recession. However, despite the sharp curtailment of economic activity Canadian inflation pressures remained virulent, with the GNP deflator posting a 10.6% rise. Although some signs of a recovery have recently emerged, the data are not positive enough to say that a rebound is definitely under way. Industrial production is still sluggish, and unemployment is still uncomfortably high at 12.5%. Moreover, housing starts have recently eased from their sharp increase in January. New manufacturing orders, as well, have not shown consistent growth. The soon-to-be-released federal budget will most likely show a large deficit to be financed, which might limit the extent of interest-rate declines. On balance, the worst is over for Canada, but better times are still more of a hope than a reality.

Australian devaluation promises balance-of-payments improvements.

Newly elected Australian Prime Minister Hawke's first major policy move was to devalue the Australian dollar by 10%. This will reduce the trade deficit—previously forecast to be at least $5 billion this year—by slowing imports and boosting exports. Hawke's alternative was to exhaust the country's reserves in what probably would have proven to be a futile effort to prevent the Australian dollar from declining; such a course, at best, would have merely delayed the inevitable exchange-rate adjustment. Devaluation will not only defend reserves, but also should produce a stable or even slightly appreciating Australian dollar in 1983. A stronger currency will encourage capital inflows, which could prove even more important to the Australian balance of payments than the improvement in the trade account that the devaluation will also engineer. The only danger in the devaluation is that it could worsen the already serious problem of inflation—the root cause of the Australian dollar's weakness in the first place.

New fiscal year marks tax-law changes in India.

India's recently announced budget for fiscal 1983/84 starting April 1 aims to encourage production and promote saving and investment while containing the deficit. Development spending is slated to increase 21%, but total spending is expected to rise by only 10%. Additional taxation of 7.16 billion rupees has been proposed, including a five-percentage-point increase in the auxiliary customs duty. This comes on top of a major extra-budgetary fund-raising effort that included sharp increases in petroleum prices and railway rates, along with higher postal and telecommunications tariffs. A minimum corporate tax has been levied and the corporate surcharge increased. But business has also been granted increased depreciation allowances and excise-duty concessions for higher production. In addition, tax concessions to nonresident Indians remitting savings for investment at home have been liberalized considerably. The net result is a projected overall budget deficit of 108.1 billion rupees, compared with 106.8 billion rupees in 1982/83.

Rising import demand could lead to reversal of Kenya's current-account gains.

Even though the decline in Kenya's terms of trade appears to have been arrested, the downtrend in the country's current-account deficit since 1981—to around $400 million this year—could easily be reversed in 1984 because of the need for increased imports. And because there appears to be no relief in sight from a severe foreign-exchange shortage, the country will have to face some difficult decisions over the near term. Some funds could be freed by diverting multilateral and bilateral loan commitments from project financing to balance-of-payments support. However, such a move would constrain development and economic growth at a time when per-capita real incomes are continuing to decline. Also, it is unlikely that any moves that would further increase debt-service obligations —already forecast to top 25% of foreign-exchange earnings in 1984—represent a viable option. Thus, Kenya can be expected to join the ranks of sub-Saharan nations experiencing an increased dependence on foreign donors for financial support on softened terms.

Social Security—Avoiding the Inevitable

Although there is still no consensus on Capitol Hill about how—or even whether—the overall budget deficit should be narrowed, Congress last month exhibited rare unanimity and speed in addressing the financial problems of the Social Security system. Legislation was enacted to close the $150-200 billion funding shortfall expected to be incurred over the balance of the 1980s. But while this legislation has been widely acclaimed for putting Social Security back on firm ground, the system's problems are far from solved.

Concerns about the long-range financial viability of the Social Security system started to emerge in the mid-1970s. The ratio of trust-fund reserves to annual expenditures fell below 100% for the first time in 1972, and below 50% in 1977. The drawdown in reserves was the result of a 20% increase in benefits in 1972 and the advent of indexation of payouts in 1975—without compensating increases in taxation. More important, estimates of the future unfunded liabilities of the system increased by more than twelvefold, from just over $400 billion in 1972 to a staggering $5 trillion in 1977.

Legislation in 1977 attempted to correct these financial difficulties. Both the tax rate and the wage base to which the rate applies were raised over and above the increases that already had been scheduled. However, even these hikes were not large enough to stop the decline in reserves. Moreover, unfunded liabilities fell by only 25%.

The recessions of 1980 and 1981-82 turned Social Security's chronic problems into painfully acute stresses that threatened the government's ability to keep the checks going out each month. Receipts fell behind as employment declined, and higher-than-expected inflation rapidly drove up expenditures. As a result, reserves dwindled to less than two months of outlays, barely sufficient to cover seasonal shortfalls in receipts. And the unfunded future liabilities of the system soared to more than $6 trillion.

Amidst this sort of crisis atmosphere—not to mention Congressional elections—a blue-ribbon commission on Social Security reform, appointed by President Reagan, eventually was able to reach a bipartisan consensus to alleviate the immediate financial strain. The commission recommended and Congress enacted a whole host of tax increases and benefit reductions that spread the costs of "saving" Social Security across an extremely wide spectrum. Still, however, the legislation is generally incremental in nature. More radical solutions such as making Social Security a voluntary program, converting it to a fully-funded pension program, or changing it to be "need-based" were rejected.

The highlights of the recent legislation fall into three main categories:

Tax increases

- Raise 1984 payroll tax rates by 0.3 percentage points for both employers and employees; accelerate part of scheduled 1990 increases to 1988.
- Raise the Social Security tax for self-employed individuals by one-third.
- Extend coverage to all new federal employees and all employees of nonprofit organizations; prohibit withdrawals by state and local governments.

Benefit decreases

- Postpone July's scheduled cost-of-living adjustment to January 1984; no future adjustments if the annual increase in the Consumer Price Index (CPI) is less than 3%.
- Use the lower of a wage index or the CPI if reserves fall below 20% of annual expenditures.

Infusions of general revenues

- Allow individuals a credit against income taxes equal to their payroll tax rate increase in 1984.
- Allow 50% of tax paid by self-employed persons to be deductible against income (not deductible under previous law).
- Tax the benefits of recipients earning above certain income levels, with proceeds turned over to the trust fund.

Unfortunately, as it has in the past, Congress focused on the short-run solvency of the Social Security system, without fully addressing its longer-run health. For example, extending the system's coverage to make it nearly universal brings in a lot of revenue in the short run, but also adds significantly to the long-run liabilities.

The legislation's one significant departure from past tradition involves the direct and indirect infusion of general tax revenue into Social Security. Proponents of such transfers argue that they are long overdue, citing the fact that surpluses in the earlier years of the program's existence had helped finance overall budget deficits. On the other hand, opponents contend that transferring general tax revenue into the trust funds compromises Social Security as a retirement program and emphasizes its income redistribution aspects.

In response to this initial "commingling" of funds, pressures to remove the Social Security Administration from the unified budget or to give it independent-agency status can be expected to increase. The reform commission itself recommended such a move, and a study on the issue of agency status was mandated in the legislation. If either of these actions is successful in limiting the use of general revenue in the future, the Social Security system may well have to undergo the radical transformation that was so carefully avoided in the latest legislation. And the staggering burden of the program's unfunded liabilities will force choices between tax increases and benefit reductions that have thus far been too painful to make.

Douglas L. Bendt

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS 6 months ending	EXPORTS 12-month change	GNP IN 1981 in billions of dollars	GNP IN 1981 $ per capita	BALANCE OF PAYMENTS latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	MONEY AND BANKING 12-month changes latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars April 6, 1983	change from year earlier	current monetary conditions	COUNTRIES
Asia	Bangladesh	Government estimates real growth at 4% for fiscal year ending June 30th.	Dec.	+12%	10.8°	120	Feb.	197	— 8%	1.1	407	New aid commitments totaling $2.2 billion being sought for 1983/84.	Dec.	+ 5%	Nov.	+ 6%	.0415	—20%	IMF loan of $73.8 million received.	Bangladesh
	Burma	Fuel shortages arising from decline in domestic oil production constraining economic activity.	Dec.	—29%	5.8°	159	Feb.	56	— 75%	1.9	71	Depressed commodity markets cause exports to fall 40% below target.	Dec.	+ 4%	Aug.	+ 8%	.1317	— 2%	Kyat peg causing official and black market rates to diverge.	Burma
	China, People's Republic	Industrial growth of 7.4%, record grain harvest of 344 million metric tons posted in 1982.	Dec.	+ 3%	260.0	260	Sept.	9,444	+140%	6.7	492	Import growth accelerating after unprecedented $4.6 billion trade surplus.	Dec. '81	+ 3%	Sept.	+12%	.5151	— 8%	Investment growth to boost deficits in 1983.	China, People's Republic
	Hong Kong	Budget deficit of HK$3.2 billion forecast for 1983/84.	Jan.	+ 2%	24.2	4,695	n. a.	—	—	—	—	Exports expected to rise about 7% this year.	Jan.	+10%	Jan.	+ 5%	.1490	—13%	Money growth modest, but rates are down.	Hong Kong
	India	Budget for fiscal 1983/84 provides incentives for production, investment, and savings.	Sept.	— 9%	161.4°	236	July	4,524	— 16%	4.4	2,279	Auxiliary customs duties raised; incentives given for remittances, exports.	Oct.	+ 7%	April	+ 9%	.1000	—16%	Interest rates cut 150 basis points.	India
	Indonesia	Government spending likely to be cut in line with new oil prices.	Aug.	—15%	81.5	541	Jan.	3,060	— 44%	2.3	71	Rupiah maxi-devaluation will improve current account, stem reserve outflow.	Jan.	+10%	Oct.	+22%	.00103	—35%	Tighter credit conditions likely.	Indonesia
	Japan	Stimulus measures announced as unemployment in January reached all-time high.	Jan.	+13%	1,142.0	9,707	Feb.	23,930	— 14%	2.3	0	Exports begin to show signs of possible revival.	Feb.	+ 2%	Jan.	+ 3%	.00421	+ 3%	Pressure builds for discount-rate cut despite yen weakness.	Japan
	Korea	Export-led recovery looks possible in 1983.	Jan.	+ 1%	62.3	1,610	Feb.	2,378	— 16%	1.2	1,244	World recovery should help current account.	March	+ 5%	Nov.	+53%	.00132	— 7%	Authorities slow rapid increase in monetary aggregates.	Korea
	Malaysia	Government projecting real growth of 4.5% in 1983.	Nov.	+10%	24.0	1,666	Jan.	3,755	— 9%	3.6	271	Export volume increased to offset $5.50/barrel crude-oil price cut.	Dec.	+ 5%	Dec.	+13%	.4376	+ 2%	Interest rates decline.	Malaysia
	Nepal	Food production reported 20%-25% short of target owing to poor weather.	Dec.	—45%	2.5°	165	Feb.	184	— 7%	5.4	14	Rupee steady after January devaluation.	Dec.	+10%	Aug.	+12%	.0699	— 8%	Liberal credit policies adopted.	Nepal
	Pakistan	Prospects good for record wheat crop.	Dec.	—10%	30.9°	360	Feb.	1,343	+ 90%	3.1	1,334	Rupee depreciation aiding nontraditional exports, but rice prices down sharply.	Jan.	+ 5%	Dec.	+20%	.0710	—30%	Drawing under IMF Extended Fund Facility resumed.	Pakistan
	Philippines	Drought and government austerity measures depressing activity.	Oct.	—10%	38.7	781	Feb.	1,464	— 27%	2.1	807	Commodity-price recovery, oil-price and interest-rate declines improve outlook.	Dec.	+ 7%	Jan.	+ 4%	.1030	—15%	Domestic credit expansion to be held to 20%.	Philippines
	Singapore	World recession finally hits home.	Dec.	— 5%	12.5	5,121	Nov.	8,023†	+ 7%	3.5	0	Reserves rising despite export slowdown.	Jan.	0	Nov.	+14%	.4739	+ 1%	Money-supply growth rapid and interest rates falling.	Singapore
	Sri Lanka	Budget calls for sharply higher government spending, increase in Business Turnover Tax.	Nov.	—11%	4.4	294	Feb.	293	— 3%	1.8	345	Import duties raised sharply.	Jan.	+ 6%	Oct.	+20%	.0437	—13%	Planned budget deficit large, but bank borrowing small.	Sri Lanka
	Taiwan	Business conditions likely to improve with world recovery.	Sept.	+ 3%	46.0	2,559	Sept.	7,897	+ 51%	5.1	0	Reserves rising extremely rapidly.	Sept.	+ 2%	Sept.	+21%	.0250	—11%	Money-supply growth is robust.	Taiwan
	Thailand	Production from Shell oil field lower than expected; gas production remains disappointing.	Dec.	— 8%	36.1	750	Feb.	1,561	+ 11%	2.2	692	Poor 1982 crops, EEC tapioca quota depressing exports.	Feb.	+ 3%	Sept.	+11%	.0430	— 7%	Real rates remain extremely high.	Thailand
Oceania	Australia	End of drought and impending world recovery promise boost in economic activity.	Dec.	— 2%	158.0	10,632	Feb.	5,691	+350%	2.7	35	Devaluation will improve current account, encourage capital inflows.	Dec.	+11%	Jan.	+ 1%	.8671	—17%	Interest rate spike before devaluation reversed.	Australia
	New Zealand	True recovery awaits rises in wool and mutton prices.	Dec.	+ 1%	23.5°	7,510	Feb.	814	+ 93%	1.8	3	Lamb prices down 15% in 1982.	Dec.	+15%	Jan.	+ 2%	.6560	—14%	Money-supply growth is robust.	New Zealand

°Fiscal year †Includes gold holdings

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World Interest Rates

market rates as of April 6, 1983; bond yields as of April 1, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.42	10.563 intervention rate	11.00	9.50	4.00	18.00 penalty rate 21.00	3.50	4.00	5.50
Day-to-Day Money	8.75 April 7	9.25	10.625	12.00	12.75	5.05	19.25	4.00	4.25 1-month Euro-Swiss fr. rate	6.625
Treasury Bills 91-day, Middle Rates	8.63	9.20	9.938	11.40	n. a.	n. a.	17.50 85 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	9.125 finance paper discount basis	9.45 finance paper 15% tax w/h	10.06	10.90 Certified	12.50 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.75	9.35 15% tax w/h	9.813	10.90 Certified	not traded	5.30	19.30	no market	4.125	no market
Government Bonds Long-term, new and old issues, average yield	10.85	11.90	10.61	10.45	13.73	7.55	18.67	7.81	4.48	7.072
Industrial Bonds prime, long-term, new and old issues, average yield	11.65 Aa Industrials	12.75	12.34	12.38	14.99	7.60	18.04	8.19	5.79	6.43
Bank Short-Term Rate (prime rate)	10.50	11.50	10.50	15.00	14.55	8.00	19.50 ½ qtrly fee on outstdng.	6.00	7.50	6.00
Bank Time Deposits 3-month	8.75 Cert. of Dep.	9.063	10.188	12.00	12.50	5.05	11.50	4.375 large deposits	2.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.625	9.688	10.438	no market	15.375	5.125	no market	4.563	4.063	6.50
Exchange Rates—in U.S.$ rates floating against the $	—	.8104	1.514	.0209	.1384	.4148	.0007	.3684	.4882	.0042
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.049 *P*	.528 *D*	2.359 *D*	4.913 *D*	4.629 *P*	8.608 *D*	5.320 *P*	5.653 *P*	3.126 *P*

Eurodollar Deposits
(London, Interbank, bid)
April 7

7-day	9.313
1-month	9.375
3-month	9.375
6-month	9.50

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.644
U.S.-Canada Treasury Bills	−0.289
U.S.-Canada Finance Co. Paper	−0.244
Eurodollars-U.K. Local Auth. Deposits	−0.034

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.75
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	7.50
Over 7 yrs.	7.75

Gold Price
London afternoon fixing
428.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Feb.) 3.5	(Feb.) 7.4	(Feb.) 5.3	(Feb.) 9.2	(Mar.) 3.5	(Mar.) 16.4	(Feb.) 4.8	(Mar.) 2.5
Industrial production*	(Feb.) −3.9	(Jan.) −6.2	(Jan.) 2.2	(Jan.) −1.6	(Jan.) −1.9	(Jan.) −4.9	(Sept.) −8.0	(Feb.) −1.7
Trade balance† *(billions of local currency units)*	(Feb.) −$3.58	(Feb.) C$1.44	(Feb.) −£0.14	(Feb.) −FF7.60	(Feb.) DM3.70	(Jan.) −Lit.2,620	(Feb.) −SF0.70	(Feb.) ¥507.9
Money supply (M1)*	(Feb.) 8.9	(Feb.) 9.6	(Jan.) 10.2	(Nov.) 12.0	(Jan.) 9.3	(Oct.) 15.1	(Dec.) 10.9	(Jan.) 7.3
Velocity of money (M1)*	(Dec.) −4.9	(Sept.) 0.8	(Sept.)** −4.6	(June)** 2.2	(Dec.) −3.8	(Sept.)** 2.8	(Mar.)** 9.3	(Sept.) 0.1
Reserves minus gold *($ million, change from previous month)*	(Jan.) −18	(Jan.) 330	(Jan.) −1,559	(Jan.) 2,945	(Jan.) 1,395	(Jan.) 1,149	(Jan.) −2,709	(Jan.) 329

* Percent change from 12 months earlier. ** based on GDP. † Figures are only for the month indicated.

Williamsburg: The Road Back to Bretton Woods?

A fundamental reassessment of the world's experience with floating exchange rates is under way—ironically coinciding with the 10th anniversary of the demise of the Bretton Woods system of fixed exchange rates. Out of the economic summit meeting in Versailles last summer came a study, coordinated by the U.S. Treasury, on the experience with intervention by all central banks over the last decade. It reached an essentially neutral conclusion. Since then, however, reports on the purported virtues of intervention have been coming in thick and fast—with a favorable study by the Federal Reserve now nearing completion. The political pressures for intervention are overwhelming. And agreement on the principle of a return to active, coordinated intervention by all the major central banks —with "target zones" for the world's key currencies—now appears certain to come out of this year's summit meeting in Williamsburg, Virginia, at the end of May.

The rationale for a return to more-stable currencies is straightforward: Exchange-rate fluctuations have simply become too volatile, carrying too high a social cost. This experience contrasts with the optimism prior to the shift to floating rates in the early 1970s, when economic theorists were predicting that such a move would lead to three developments:

- First, exchange rates would adjust continuously and smoothly to new information and thus provide an equilibrating force that would harmonize the world economies. This view was based on the belief that the foreign-exchange market is efficient and would thus discount all new information and forecasts. Shocks to the market would come only from wholly unforecastable events, such as central bank intervention or wars.
- Second, purely floating exchange rates would restore monetary independence to individual countries. Under a fixed-exchange-rate regime a central bank is obligated to exchange any volume of foreign currency into its own currency. The experience during the late 1960s was that because of the persistent U.S. balance-of-payments deficit, the Bundesbank was continuously being forced to exchange dollars for marks. This led to high growth in the German money supply and consequently increased German inflation—and to European accusations that the United States was "exporting" inflation.
- Third, floating exchange rates would reduce the dollar's dominance over the world monetary system. Independent financial markets would develop, providing genuinely separate financing and investment media. This prediction spurred hopes that the world would evolve toward a multiple-reserve-currency system, with the possible emergence of a "world currency" along the lines of what later became the IMF's Special Drawing Rights.

Unfortunately, none of these theoretical predictions have proved to be valid. Exchange rates have become progressively more variable. Analysis based on so-called "economic fundamentals" has failed to forecast, for example, the persistent 20% overvaluation of U.S.-traded goods above Japanese goods prices. However, models based on currency substitution *have* forecast this—in contradiction to the instantaneous discounting of efficient-markets theory. Short-run volatility has also increased enormously. It is now common to have one-percentage-point moves in major currency values overnight. And these fluctuations tend to turn into trends—witness the 20% decline in the dollar relative to the yen in the last eight weeks of 1982.

Furthermore, monetary independence is virtually non-existent because of the continued de-facto dominance of the world monetary system by the dollar. For example, if the Fed tightens monetary policy aggressively at a time when another country is easing its policy, then there will be a major shift of investment into the dollar and a shift of borrowing into the other currency. In fact, these shifts in the currency denomination of asset and liability peference are now the moving force behind changes in currency values.

Is intervention the answer?

The predominant view of economic theorists used to be that the foreign-exchange market in the major freely traded currencies is "efficient." This means that: (1) information on all forces affecting the market is available at low cost, (2) there are very few barriers to entry to the marketplace, and (3) there are no dominant participants in the market. In such a market all known information and forecasts are instantaneously reflected in the current exchange rates.

One major corollary to this statement, which can be statistically tested, is that there should never be discernible trends in currencies that can be traded upon consistently for profit—at low risk. If there were, for example, a clear uptrend in the dollar, then speculators would immediately buy the dollar, pushing it up to the point where the best guess of the next move is—sideways. In fact, however, the history of floating exchange rates disproves this. Low risk currency trends do exist—and persist.

From the perspective of efficient-markets theory, central bank intervention can be effective in changing trends only if either (a) the intervention is so heavy that it destroys market efficiency, or (b) the intervention is based on more perfect insights into future developments than the combined judgment of the market participants.

According to the theorists, the acid test of effective foreign-exchange intervention is whether it turns out to

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be profitable—and not just in terms of one currency. If it is profitable, then the insights of the intervening central bank were correct; thus, the intervention gave the correct signals to the market and speeded the move toward a new equilibrium. If the intervention is unprofitable, then the central bank will have merely sidetracked the market and postponed making needed adjustments in domestic policies. In the vast majority of historical studies on intervention, the latter proved to be the case: Intervention was unprofitable and largely undertaken with the forlorn hope that an adjustment in domestic policies would not be required.

Furthermore, both risk and the potential future costs of policy flexibility must also be taken into account. For example, it is clearly possible for a central bank to fix an exchange rate at any value for any period of time. But if the rate chosen is out of line with the private market's view, then such a policy carries with it extremely high risks—not only that the free markets will be severely distorted, but also that a large part of the populace will be put out of a job by the central bank's attempt to hold the rate. Even if intervention is profitable with no major immediate indirect costs, the costs of acquiring and holding foreign-exchange reserves may deeply compromise future policy flexibility. In the extreme situation—which unfortunately does occur—a near-total loss of reserves can subsequently lead to spiraling devaluation and severe disruption of the economy.

Target zones—the first step

Although most of the earlier studies on intervention suggest it is valueless or disruptive, the fact i that the implicit intent of almost all intervention actions in the past was to postpone or avoid domestic policy actions—not to solve problems in the foreign-currency markets per se. For instance, the failed intervention to support the dollar during 1976-78 was, in reality, an attempt by the United States to postpone the politically painful process of raising the U.S. gasoline price to the world price level—and in that it was, of course, successful.

The fact that the one-percentage-point overnight currency moves are disruptive to world commerce provides interventionists a prima facie case for intervention to stabilize short-run exchange-market fluctuations. The most popular proposal at present is the target-zone idea: Central banks would intervene flexibly on both sides of a pre-agreed but unannounced band that would move over time. The theory is that the visible presence of the central banks would eliminate the tendency for currency "runs" to occur. This would enable "regressive," or stabilizing, expectations to emerge and, by reducing the high uncertainty premium, encourage longer-term stabilizing speculations.

The proponents of intervention see this as a first step back toward Bretton Woods—back to fixed exchange rates with a role for gold. However, except in the aftermath of world financial crisis, a return to fixed exchange relationships maintained by intervention is simply not feasible. There are three main reasons for this:

- First, the volume of potential arbitrage would overwhelm the total reserves of all the central banks. If exchange rates are fixed for even one month, all the one-month interest rates will be forced into instant equality with incredibly large capital flows—perhaps more than $50 billion by major U.S. financial institutions alone in the first two weeks. The clearing interest rate in such a world would be primarily set—as it currently is—by the deepest market: the dollar market. This would leave real interst rates in different markets in acute disequilibria and would severely tax employment in countries with inflation rates lower than that of the United States, to the benefit of higher-inflation countries. This would be totally unacceptable to politicians who want harmonized policies, but at no cost.
- Second, real exchange rates have been at such acute disequilibria over the past five years that there has been a massive redistribution of worldwide production. As a result, there are now self-perpetuating instabilities that would overwhelm intervention. Thus if the dollar is permanently fixed at current levels, then large sectors of U.S. manufacturing industry may never recover.
- Third and finally, there is arithmetic to contend with. In principle, the balances of payments of all countries must sum to zero (in practice, they do not because of measurement errors); someone's surplus must be matched by another country's deficit. If all countries try to achieve a payments surplus, at least one country must lose. Since the dollar enjoys the role of world money, it is the primary buffer for disequilibrium in the international balance of payments.

Seen in this light, intervention between the major asset currencies is madness. But logic and experience have never been a powerful motivating force behind political decisions. Central banks exist to intervene and control free markets. They have to operate on the belief that they are privy to unique and deeper insights than the free market—and that they are not the source of instabilitiy. Otherwise they have no raison d'etre. Central banks realize that a return to fixed exchange rates is currently a technical and political impossibility. Nevertheless, the lure of the power to intervene and to "stabilize" the world economy is too great to be resisted. Hence, a move back to active, coordinated intervention by the major central banks seems to be politically inevitable.

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